BlackRock

Financial resilience in a new economic regime

January 2024

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Foreword

Over the past year, investors continued to navigate a complex macroeconomic environment with slower growth across several major markets. Supply constraints compelled central banks in developed markets to keep policy rates high, even as credit supply tightened. Although inflation is easing and policy rates are set to come down, it is becoming clear that this is a new regime, shaped by powerful structural forces driving divergent performance across economies, sectors and companies.

Investors are seeking to understand how these forces will shape both future economic performance and the returns at companies they invest in: how will a reshaping financial system change the way companies are financed? How will geopolitical fragmentation rewire supply chains as governments realign trade and production with a focus on national security? How might artificial intelligence supercharge productivity in some sectors and disrupt others over the coming years? How will a transition to a low-carbon economy unfold across markets? And how will companies adapt to labor shortages as populations age across major economies?

Investment stewardship is one of the ways in which BlackRock fulfills our fiduciary responsibilities as an asset manager to our clients. We serve as a link between them and the companies they invest in. Over the past year, we had thousands of conversations with companies about these structural changes, among other topics, to understand how they might impact financial returns to our clients invested in these companies.

We found many companies focused on adapting their strategies and business models, to both manage the risks in this complex environment and capture opportunities spurred by it. We saw companies reexamine their balance sheets and cost structures to bolster their financial resilience in an environment of slower growth and higher interest rates. We also saw leadership teams position their businesses to enable robust and dynamic decision-making in a rapidly evolving environment.

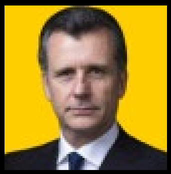
As one of many shareholders, and typically a minority one, BlackRock does not tell companies what to do. Our role, on behalf of our clients as long-term investors, is to better understand how corporate leadership is managing risks and opportunities to help protect and enhance their company's ability to deliver financial returns over time.

In this paper, we highlight structural shifts that we believe are shaping this new economic regime. We discuss how companies are adapting to harness opportunities catalyzed by it, based on our investment stewardship team's conversations with company leadership.

We are interested in learning through our engagements how companies are adapting to strengthen their financial resilience in this new regime. As always, our discussions will encompass our evergreen stewardship engagement priorities, of which strategy and financial resilience is one. We look forward to our continued dialogue with companies in 2024.

Joud Abdel Majeid
Global Head of BlackRock Investment Stewardship

Rich Kushel
Head of the Portfolio Management Group – BlackRock



Philipp Hildebrand
Vice Chairman – BlackRock

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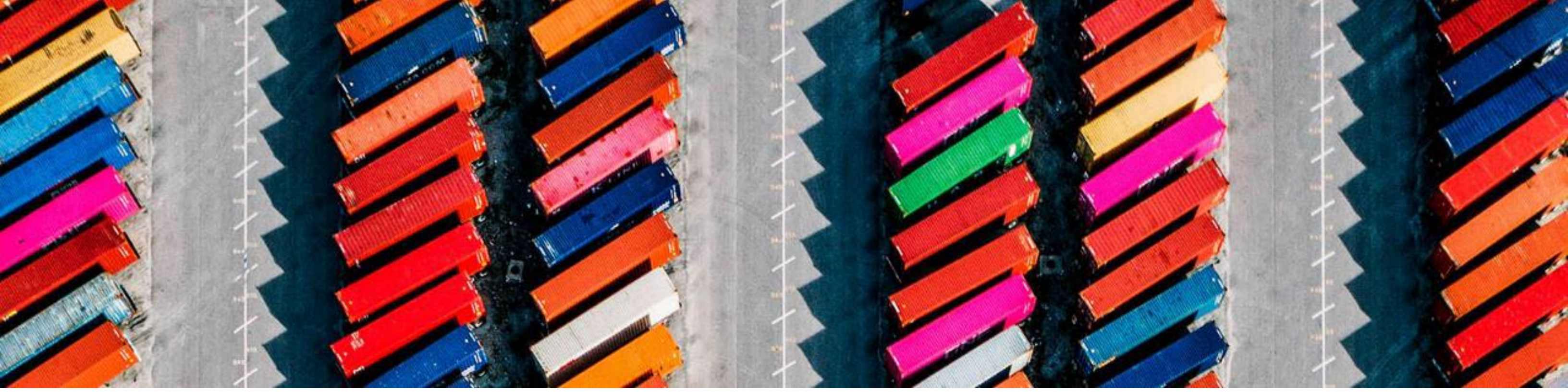


Summary

The business environment companies are operating in has changed. Companies are navigating a new regime of muted economic growth in many advanced economies, greater inflation pressures and higher interest rates. A range of production constraints are limiting how much those economies can produce and grow in the future before prices start rising too quickly. Even as pandemic-related inflation pressures abate and interest rates fall from their peaks, central banks may have to keep rates higher than they were before the pandemic, compromising growth if they want to avoid resurgent inflation.[1]

In our engagements with companies, many have told us that they are reassessing their financial position to ensure they are resilient to structurally slower economic growth and a higher cost of capital. They are considering how to adapt to a reshaping financial landscape, as banks face tighter regulation and greater competition for customer deposits and the supply of credit from banks tightens. CEOs and CFOs are thinking about how to unlock operational efficiency, optimize their balance sheets, and enhance capital allocation.

At the same time, a set of mega forces –large, long-term structural shifts – are changing how economies are structured, how consumers and governments spend, and how companies operate.[2] In addition to a reshaping financial landscape, we see four forces driving significant shifts in profitability across sectors and companies:[3]

- **Digital disruption and artificial intelligence (AI) –** Generative AI-based solutions could streamline operations, improve customer experience, and enable new capabilities. Tech firms are already pivoting their businesses around generative AI. We see opportunities across other sectors and a potentially transformative impact on profitability and productivity. Managing data privacy and cybersecurity risks will likely become increasingly important.
- **Geopolitical fragmentation and economic competition –** Geopolitical fragmentation and mounting competition between countries are rewiring globalization. We see companies reconfiguring their supply chains to adapt to growing regulation and mitigate risk in their operations, often increasing costs. At the same time, we also see them capitalizing on industrial policy to spur innovation and diversify their business models.
- **Transition to a low-carbon economy –** Public policy, technology, and consumer and investor preferences are shaping the low-carbon transition, creating both risks and new opportunities for companies. Growing demand for climate resilience solutions has propelled product innovation opportunities.
- **Demographic divergence –** Workforces are growing more slowly as populations age in major economies, making labor more scarce and costly. Companies are exploring how to attract and retain talent, automate production or offshore operations to emerging market economies with younger populations.

A set of mega forces –large, long-term structural shifts – are changing how economies are structured, how consumers and governments spend, and how companies operate.

Against the backdrop of these shifts, we expect to see a wider range of company performance – with companies that can harness these forces and capitalize on them outperforming, while those that struggle to adapt could underperform. That wider range of outcomes – and the uncertainty that comes with it – is reflected in an unusually wide range of analyst estimates of future company earnings, according to LSEG data – see Figure 1.

We believe the choices companies make as they adapt to this new regime to be an important driver of their long-term financial performance. In our engagements with companies, and through reviewing their disclosures, BlackRock Investment Stewardship (BIS) seeks to understand how they are positioned to create value and deliver financial returns in this regime for their long-term investors, like our clients. We are interested in understanding how companies are:

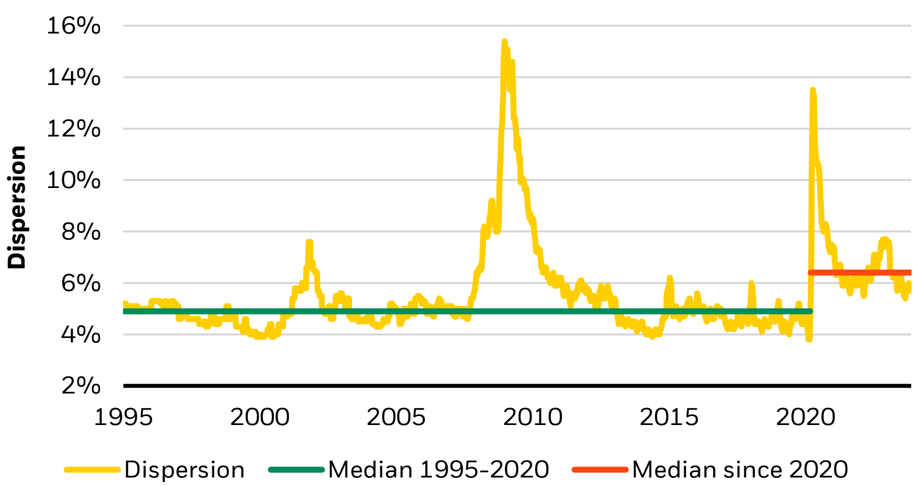
- strengthening their financial resilience in an environment of higher interest rates;
- adapting their business models to capture relevant opportunities in this new regime and manage their risks; and
- positioning for change in a fast-evolving and more uncertain operating environment.

Over the following pages, we outline what companies have told us about how they are evolving their businesses to be well positioned.

We believe the choices companies make as they adapt to this new regime to be an important driver of long-term financial performance.

Figure 1: An outlook that's harder to read

Dispersion of equity earnings estimates, 1995-2023



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, LSEG Datastream, January 2024. Notes: The chart shows the aggregate standard deviation of analyst earnings estimates for S&P companies. The green line shows the median from 1995 to end January 2020, the orange line shows the median since February 2020.

Strengthening financial resilience

Amid a slower growth and higher interest rate environment, companies tell us in our engagements that they are focused on building stronger balance sheets, increasing free cash flow generation, and improving their capacity for sustained earnings growth. We note their focus on three areas:

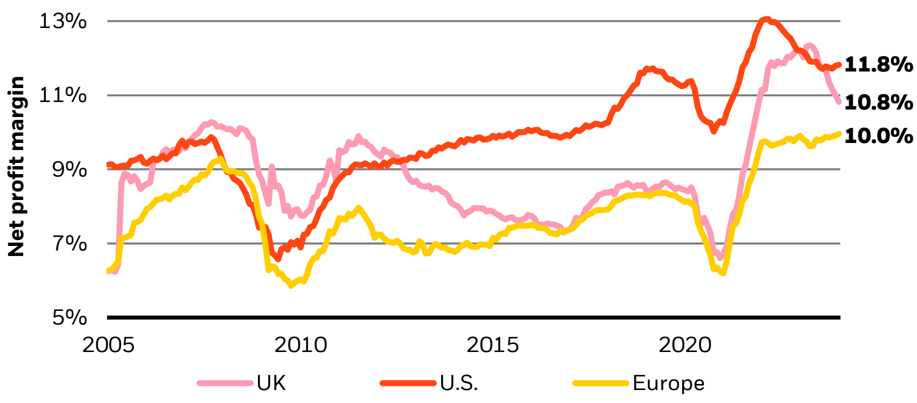
Driving operational efficiency

Company profit margins have expanded over the past decade,[4] as companies benefited from globalization and lower interest rates – see Figure 2. Companies now face the challenge of adapting to the new macro regime and protecting their margins, while building resilience.

To fund new growth opportunities and create financial value, companies are re-examining their cost base. Over the past year, we have seen many companies restructure their organizations, reduce discretionary spending, and enhance procurement processes to create scale and efficiencies. We saw others simplify product lines or exit noncore businesses to reduce fixed costs.

Some companies are streamlining their business models to reduce working capital and therefore the cost to finance it. In the industrial, retail, and consumer goods sectors, for example, we observed some companies reduce the capital intensity of their business by optimizing inventory management, even when it might impact the speed with which they fulfill their orders.

Figure 2: Equities profit margin (12-month forward)



Source: LSEG Datastream, BlackRock Investment Institute. January 2, 2024.
Notes: 12-month forward profit margin as calculated by 12-month forward total earnings divided by sales.

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Optimizing balance sheets

Bloomberg data show around USD $2 trillion of corporate debt will mature over the next three years – see Figure 3. Many companies will need to refinance at higher interest rates, which could be particularly challenging for companies with a lower credit rating. In 2023, we saw companies with high debt levels seek to refinance, restructure, or extend loans – likely at a higher cost but with the hope of securing more advantageous conditions later. In the U.S., companies issued USD $48 billion of convertible debt in 2023, representing a 77% increase compared to 2022, as they sought to manage their borrowing costs.[5]

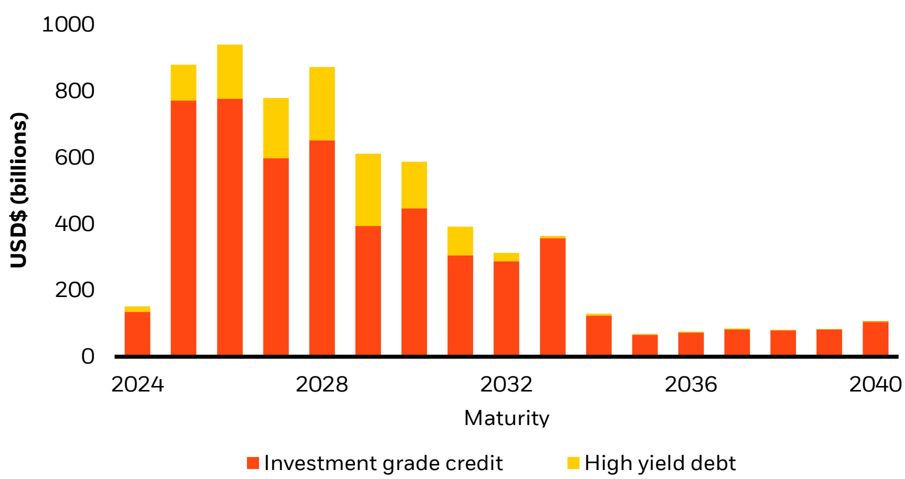
The higher cost and scarcity of capital has led some companies to take more structural measures including streamlining their business model and divesting noncore assets to accelerate deleveraging. The number of divestiture transactions remains close to three-year high after a couple of years of reduced activity. In Q3 2023, 460 divestiture transactions took place in the U.S., a 74% increase compared to Q3 2022, as companies sought to redeploy capital from noncore assets to new areas of growth, or to deleverage.[6] A backlog of transactions initiated a few years ago has also contributed to this increase.[7]

Companies are also opportunistically examining their funding sources in a reshaping financial ecosystem. In the U.S., as interest rates have risen, banks are increasingly competing for customer deposits. This, along with the prospect of increased regulation, have contributed to reduced bank lending. As bank loans have become more expensive, capital markets and private credit have become relatively more attractive to companies as a source of financing.[8]

In our view, companies that are most proactive about their capital structure are likely to be the best positioned to manage any short-term liquidity issues and strengthen the long-term resilience of their balance sheets.

Figure 3: Refinancing on the horizon

Credit maturity, Q3 2023



It is not possible to invest directly in an index. Index returns do not account for fees. Source: BlackRock Investment Institute, with data from Bloomberg, November 2023. Notes: The chart shows the market value in U.S. dollar (billion) of the investment grade (IG) and high yield (HY) credit markets by the bond maturity year. The index proxies are: Bloomberg U.S. Credit for investment grade credit and Bloomberg US Corporate for high yield debt.

Reviewing capital allocation

The strategic deployment of capital has become increasingly important for companies. We have seen companies reassess the value of growth initiatives in the context of a higher cost of capital. CFOs have told us that they are re-evaluating projects with adjusted return and payback expectations. Resources are being reallocated to invest in the fast-growing businesses of the future, and not over-fund mature, declining businesses.

We are also seeing companies bring more agility and rigor to their capital review process through more frequent reviews for reallocation opportunities throughout the year. This is particularly important in an environment in which both the underwriting frameworks and the inorganic growth opportunity set are rapidly changing. That said, maintaining focus on the company's long-term strategic objectives while responding to these opportunities is equally important, in our view.

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Adapting business models…

In our engagements with companies, many tell us they are adapting their business models to capitalize on the opportunities and manage the risks stemming from these mega forces. Over the past year, we discussed these dynamics, among other topics, to understand how they might impact the financial returns of our clients invested in these companies. We outline our observations and the considerations companies have shared with us, noting the substantial interplay between the forces.

Digital disruption and AI

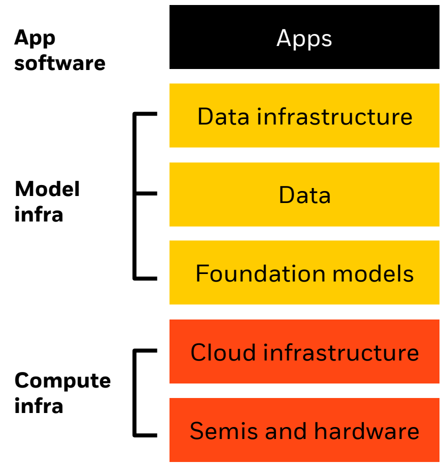
Breakthroughs in computing hardware and deep learning have catalyzed exponential advancements in generative AI. In 2023, we saw the tech industry pivot business models to AI, sparking a race led by a few companies. The hardware sector (chipmakers) was an immediate beneficiary as a provider of an essential building block for AI. We expect the next set of advancements to move up the technology "stack" to benefit data and model infrastructure providers and AI-powered applications – see Figure 4. And we are seeing technology companies hire top AI talent and invest in infrastructure.

Beyond the technology sector, AI could raise employee productivity and enable companies to serve customers more efficiently and effectively. There is a wide range of estimates of how much of a boost to productivity AI could generate, but they suggest the effect could, in time, be material. Many estimates are anchored around the apparent effect of the internet revolution, which coincided with about a 13% boost to U.S. productivity over a decade.[9]

While many sectors could benefit, we think the healthcare, retail, and financial services sectors stand in particularly good stead. For example, some drug manufacturers told us they are using generative AI to reduce research and development time and improve the quality of testing. In retail, many companies already use AI for personalized marketing, pricing strategies, supply chain and warehouse management, both to unlock new avenues for growth and to deliver efficiencies.

We are seeing early adopters re-examine their operations and the skills they might need in their future workforce. Yet rapid adoption of AI could pose risks around cybersecurity, data privacy, and algorithmic biases. Companies with robust risk management may be able to adopt AI faster and more safely, and better navigate future regulation.

Figure 4: AI goes far beyond
BlackRock view of tech needed for AI applications



Source: BlackRock Investment Institute, January 2024. Notes: The schematic shows the technologies we think will be needed – across hardware and software - to develop AI applications. Each layer builds on the one preceding as technologies get "stacked" on top of one another enabling further innovation. The schematic is for illustrative purposes only and intended as a guide based on what we know today. As the AI ecosystem evolves some categories may be replaced by newer ones.

Geopolitical fragmentation and economic competition

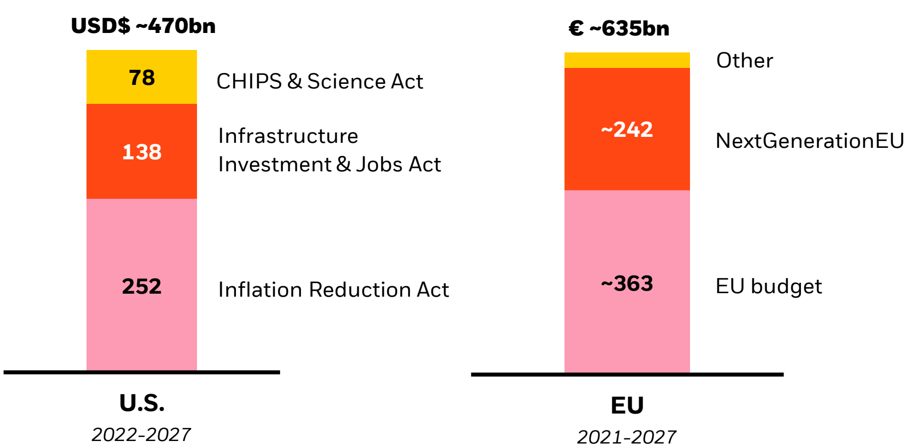
Geopolitical fragmentation and mounting competition between countries are rewiring globalization. Alongside a push for resilience, that is leading to a rethink of global supply chains. Since the pandemic, we have seen companies mitigate risk in supply chains through onshoring, near-shoring, and supplier diversification. As competing geopolitical and economic blocs firm up, the preference for resilience over economic efficiency could push up production costs unless there are large productivity gains. Companies with strong pricing power may be able to better protect their profit margins.[10]

Among suppliers, those with greater geographical diversification – or that are able to diversify their own suppliers – appear to be well positioned. We see companies focusing on leveraging the strong relationships across their value chain. For example, we have seen companies within some supply chains share some of the cost of reshoring.

Intense competition between countries, as well as domestic political concerns, is leading to the proliferation of industrial policy and a surge of investment in strategic sectors like technology, infrastructure, clean energy, and defense – see Figure 5. For example, the U.S. Inflation Reduction Act and Infrastructure Investment and Jobs Act are estimated to spur over USD $1 trillion of additional capital investment in energy supply infrastructure, including wind, solar, and battery power, through 2035.[11] We have also seen some companies rethink their operating models – and even their listing locations – to benefit from these policies.

Figure 5: Large public spending on clean energy

U.S. and EU pledged public climate funding



Source: BlackRock Investment Institute, Rocky Mountain Institute and European Commission, January 2024.
Notes: The chart shows pledged funding by region taken from "Congress's Climate Triple Whammy: Innovation, Investment, and Industrial Policy"; "Long-term EU budget 2021-2027 and recovery package"; "Fit for 55: Council and Parliament reach provisional deal …"; "Factsheet on Financing REPowerEU".

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...to harness opportunities

Transition to a low-carbon economy

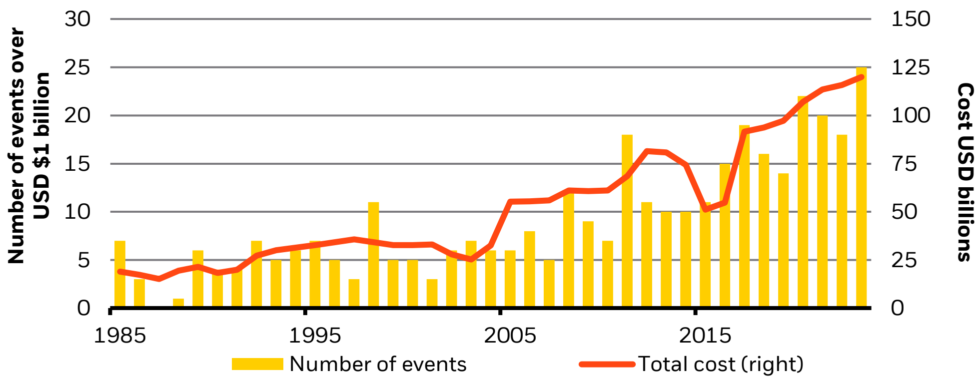
Changing government policy, technology, and consumer and investor preferences are driving a transition to a low-carbon economy. But these forces are moving at uneven speeds across sectors and regions.[12] We have heard from companies how they are managing the opportunities and risks arising from the transition and how these affect their business model, capital allocation, and investment decisions. We see many companies navigating the complexities that can arise as countries seek to ensure reliable and affordable energy during the transition. We are also observing companies plan for regulatory uncertainty across jurisdictions.

Given the uncertainty and unevenness of the transition, we see companies responding differently across regions and sectors. In the energy sector, we have seen elevated deal-making to acquire cost-competitive assets, enabled by strong balance sheets in this sector. We have seen new voluntary efforts to reduce emissions and some business model diversification to low-carbon fuels and carbon capture.

Beyond the energy sector, we see opportunities for companies that are positioned to benefit from the rising demand for the metals and materials needed in the transition, as well as for those focused on the production of electric vehicles.[13] We also see companies in the industrials and technology sectors investing in product innovation to benefit from growing demand for solutions that build resilience to a changing climate, such as air conditioning, cooling construction materials or early monitoring tools to predict flooding. We think demand for climate resilience solutions is likely to continue rising given increasing physical climate damages – see Figure 6. We have also seen companies building their own operational resilience where their business model is impacted by climate-related risks.

Figure 6: Mounting climate damages

U.S. events with losses over USD $1 billion, 1980-2023



Sources: BlackRock Investment Institute, NOAA National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2023). January 2024. Notes: The yellow bars show the number of climate events with losses greater than USD$1 billion. The data include droughts, flooding, severe storms, tropical cyclones, wildfires, winter storms and freezes. The red line shows the total cost as a ten-year average. The data are adjusted for inflation using 2022 dollars. All currency figures are in USD.

Demographic divergence

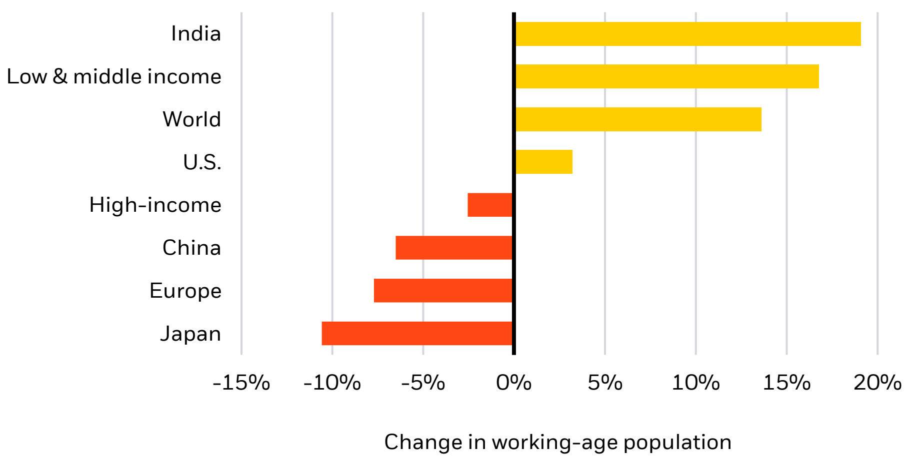
As populations across major economies age – see Figure 7 – companies in those economies will face labor shortages. Governments may also opt to increase corporate taxes to finance a range of services such as pension benefits for retired workers, putting cost pressure on companies operating in these countries.

We have observed companies using technology – and automation in particular – to cope with labor shortages and protect margins. Yet we don't think the ensuing productivity benefits will be enough to absorb all the cost pressure. That could incentivize companies to move IT or manufacturing to economies with more plentiful labor, capping the onshoring we expect due to geopolitical fragmentation but adding to supply chain rewiring.

An aging population creates new revenue opportunities as consumer needs and spending patterns shift. Sectors like healthcare and leisure are likely to grow faster than others as retirees typically spend more in these areas. Companies can also capitalize on other demographic changes. For example, in Japan, goods and services designed for households with two working parents have grown in the past decade as more women enter the workforce. We see benefits for companies that monitor consumer behavior and preferences, and develop solutions for new needs.

Figure 7: Aging populations in major economies

Change in working-age population, 2020-2035



Forward-looking estimates may not come to pass. Sources: BlackRock Investment Institute, with data from United Nations, June 2023 . Notes: The chart shows the estimated percentage change in population aged 20-64 for selected countries and regions between 2035 and 2050 based on UN data covering 237 countries or areas. Low, middle and high income groupings are based on the World Bank classification which use gross national income.

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Positioning for change

Corporate governance – and the effectiveness of leadership and management – has long been the focus of our investment stewardship program. Amid this structural transformation, our view is that robust corporate governance will be a competitive advantage in helping companies respond. We have observed corporate leaders adapt their practices to better position their companies for change. We note three areas they have highlighted.

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Enabling dynamic decision-making

In a changing economic environment, where corporate financial performance is likely to be more dispersed, management decisions – and the speed with which they can be made – are set to be even more consequential. In our engagements, companies have noted that their boards and executive leadership are focused on creating structures that enable robust and dynamic decision-making.

The board's role in advising and overseeing management through changes in strategies, business models or capital allocation plans is instrumental. We have heard from boards whose businesses are undergoing structural shifts that they are reviewing their composition to ensure they have the relevant skills – to acquire those aligned with new opportunities, while preserving those required to oversee the business today. Some have leveraged subcommittee structures or external advisors to deepen their understanding of emerging topics, like artificial intelligence, and the implications for their businesses. Many leadership teams are holding annual strategic reviews with their boards to discuss developments impacting their strategies and to provide context for their capital allocation decisions.

Investing in human capital management

How well companies attract, develop, retain, and reward employees is a key differentiator, especially during periods of change. We have heard from many companies that they are developing partnerships with universities and associations in their communities to build systematic talent pools in tight labor markets. For companies requiring additional employee skills to support new business lines, we have seen some invest in expanding the skills of their current workforce and others broaden their footprint to access a wider talent pool. Some have had to evolve their reward structures to attract talent with these new skills.

Periods of uncertainty require strong change management to retain and motivate future leaders. Boards tell us they are increasingly interested in understanding talent practices and in spending more time with leaders to better inform succession planning for key roles. Executive compensation will be in focus for investors in a period of dispersed financial performance. It will be important for companies to demonstrate – through their disclosures – that executive pay rewards realized achievements and is closely correlated with financial performance and returns to investors.

Staying connected with investors

In times of change, corporate communications play an important role in strengthening credibility with, and maintaining confidence among, investors. We see leading companies more proactively communicating how they are adapting to the opportunities and risks that most materially impact their business models. In our experience, clear, comprehensive, yet concise disclosures help investors understand the company's long-term strategy, risk and opportunity set, and management's plan to deliver financial returns through business cycles.

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Engaging on behalf of clients

Investment stewardship is one of the ways in which BlackRock fulfils our fiduciary responsibilities as an asset manager to our clients, by serving as a link between them and the companies they invest in. We take a constructive, long-term approach to our work, focused on the management and oversight of the drivers of risk and financial value creation in a company's business model.[14]

Engagement is core to our stewardship efforts. We regularly meet with companies and our engagements can span multiple years. As investors on behalf of our clients, these conversations help us understand how companies are navigating issues likely to impact their long-term financial performance and inform our proxy voting decisions. We find that most companies also welcome the dialogue as it enables them to explain their practices and understand how their investors view them.

Establishing and adapting the strategy of a company to effectively drive its long-term financial performance is the responsibility of executive leadership and the board of directors. As a long-term investor on behalf of our clients, we do not seek to direct a company's strategy or its implementation. Our role, on behalf of our clients as long-term shareholders, is to better understand how corporate leadership is managing risks and capitalizing on opportunities to help protect and enhance a company's ability to deliver long-term financial returns.

Our engagement priorities for 2024 remain consistent with previous years as they continue to reflect the corporate governance norms that, in our experience, drive long-term financial value. Amid this economic regime, we are particularly interested in how companies are adapting to strengthen their financial resilience.

To aid our understanding, our engagements with companies may include these questions, as appropriate, as shown in the table below.

Amid this economic regime, we are particularly interested in how companies are adapting to strengthen their financial resilience.

Example questions we may ask companies

Topic	Example questions
Strengthening financial resilience	• How is the company repositioning to strengthen financial resilience amid this changing economic environment? • What are the company's capital allocation priorities and how have these been affected by the new regime?
Adapting business models	• How is management identifying and assessing the potential impacts on the company's business model arising from structural changes that are relevant to their business? • How does the board develop its knowledge and understanding of the structural changes impacting the company and the implications for the long-term strategy and business model?
Positioning for change	• How does the board ensure it has the appropriate mix of skills and experience relevant to the future direction of the company? • How is leadership guiding the workforce through change?

Source: BlackRock Investment Institute, BlackRock Investment Stewardship, January 2024. Notes: The table provides an illustrative list of the types of questions we may ask companies in our discussions with them.

Endnotes

1. BlackRock Investment Institute, "2024 Global Investment Outlook"
2. BlackRock Investment Institute, "Mega forces: An investment opportunity", 2023.
3. Please see previous endnote. BlackRock Investment Institute outlines five mega forces that they are currently tracking; Demographic divergence; Digital disruption and AI; A fragmenting world; Future of finance; Low-carbon transition.
4. LSEG Datastream, BlackRock Investment Institute, Jan 02, 2024.
5. Financial Times, LSEG.
6. Deloitte, "Divestiture Quarter Update", Q3 2023.
7. Please see previous endnote.
8. BlackRock Investment Institute, "A fast-changing U.S. financial landscape", October 2023.
9. Please see: McKinsey, "The economic potential of generative AI: The next productivity frontier", July 2023. Goldman Sachs, "Generative AI could raise global GDP by 7%", April 5, 2023. Bank of America, "Artificial intelligence: A real game changer", PwC, "Sizing the prize-PwC's Global Artificial Intelligence Study: Exploiting the AI Revolution-What's the real value of AI for your business and how can you capitalise?", 2017, and CEPR, "Transatlantic technologies: Why did the ICT revolution fail to boost European productivity growth?" August 21, 2020.
10. BlackRock Investment Institute, "Geopolitical risk dashboard", December 15, 2023.
11. REPEAT, "Climate Progress and the 117th Congress: The Impacts of the Inflation Reduction Act and Infrastructure Investment and Jobs Act", July 2023. This estimate assumes neither act is revised or repealed.
12. BlackRock Investment Institute, "Tracking the low-carbon transition", July 2023.
13. BlackRock, "The brown to green transition", October 2023.
14. BIS' Engagement Priorities reflect the five themes on which we most frequently engage companies, where they are relevant, as these can be a source of material business risk or opportunity. The BIS Global Principles, regional proxy voting guidelines, and engagement priorities (collectively, the "BIS policies") set out the core elements of corporate governance that guide our investment stewardship efforts globally and within each market, including when engaging with companies and voting at shareholder meetings. The BIS policies are applied on a case-by-case basis, taking into consideration the context within which a company is operating.

Want to know more?

blackrock.com/stewardship
contactstewardship@blackrock.com

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